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SUBJECT: ARMENIAN PRIME MINISTER OUTLINES ECONOMIC
CHALLENGES TO DAS KAIDANOW

Classified By: Ambassador Marie L. Yovanovitch. Reasons 1.4 (b/d)

SUMMARY

1. (C) Armenian Prime Minister Tigran Sargsian told EUR DAS Tina Kaidanow that the current economic crisis has revealed structural weaknesses and a lack of diversification in the Armenian economy. The GOAM has borrowed heavily to counter the impact of the financial crisis, and the economy will need to return to strong growth by 2011 in order to avoid socially disruptive spending cuts and to manage the debt. Sargsian expressed hope that planned reforms in the tax and customs spheres, as well as stronger conflict-of-interest measures, will strengthen both the economy and Armenia's democratic development. END SUMMARY.

CRISIS REVEALS THE ECONOMY'S WEAKNESSES

2. (C) In their introductory meeting on October, 21, Armenian Prime Minister Tigran Sargsian outlined for DAS Tina Kaidanow the troubled state of the Armenian economy, and indicated that the crisis has revealed its structural weaknesses and lack of diversification. The country's GDP declined by 18.4 percent in the first eight months of 2009 - highest among CIS countries - though he predicts that GDP will decline by 15 percent overall in 2009. Approximately 14 percentage points of that decline resulted from a decline in construction, which had comprised 30 percent of the Armenian economy and which declined 50 percent year-on-year. Sargsian indicated that savings rates had increased during the crisis, which while a prudent measure on an individual basis, exacerbates the economic crisis on a collective basis; recovery depends on people spending more money.

3. (C) The GOAM projects overall 2009 inflation of 5-6 percent. Due to lower than expected revenue collections, the 2009 budget deficit will equal 7.5 percent of GDP, to be covered largely by loans from the IMF, World Bank, Asian Development Bank, Russia, and government-issued debt. Sargsian predicts a 2010 budget deficit of six percent, with one percent GDP growth, much of this debt again to be covered by IFI loans as well as 100 million Euros from the EU's stabilization program (35 million Euros of which will be a grant). In order to manage the resulting debt without undertaking draconian spending cuts that could cause serious social tensions, the budget deficit will need to decline to two percent of GDP in 2011-12, with growth of six percent each year. (Comment: This seems an ambitious target, given the current financial crisis and low growth prospects in 2010. End Comment).

FOUR PARADOXES OF THE ARMENIAN ECONOMY

4. (C) Sargsian highlighted four paradoxes in Armenia's economic situation. First, inflation remains surprisingly

high, given that such a steep GDP decline would normally have a deflationary effect. He attributes this to a lack of competition in the Armenian economy, where major sectors are controlled by well-connected oligarchs. Second, the official unemployment level remains at about 7.5 percent, well below what might be expected given such a huge economic decline. (Note: Armenian unemployment statistics are generally quite unreliable. Household surveys generally show the true rate to be closer to 25 percent, excluding those who have gone abroad to work. End Note). He asserted that many people who respond to surveys as "unemployed" are in fact working in the grey economy.

15. (C) Third, despite the severe economic downturn, official retail sales increased by AMD 40 billion (USD 106 million) in the first eight months of 2009. This is largely the result of last year's widespread introduction of cash registers at many retail outlets where transactions previously had gone unreported. Fourth, while consumer loans fell by 40 percent from last year, overall lending has grown. While in a declining economy it is typically SMEs that borrow more, in the current situation it is larger businesses that are doing so. This is also explained by the fact that the financial sector (e.g., lending) functions largely in the regular economy, while the real sector (ordinary goods and services) continues to exist extensively in the grey economy.

REFORMS KEY TO DEMOCRACY

16. (C) Sargsian claimed the primary reason for lack of democracy in Armenia is that the GOAM fails to provide

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adequate protection for property rights, especially for SMEs, and fails to provide equal conditions for all businesses. He hopes to address this problem through reform of tax and customs administration. If the GOAM fails to do this, "we as a nation have no future," he said. Sargsian outlined other reforms, including "blacklisting" of persons who had failed to repay bank loans, which had significantly reduced non-performing loans; creation of an independent expert working group on reform of the tax service; and a plan to bring in foreign experts to conduct random audits of three large businesses.

17. (C) Sargsian lamented that many persons want to become elected officials in order to protect or promote their business interests, rather than to be involved in public service. He suggested that this is as true of the opposition as of incumbents. To facilitate the reform process, the GOAM is preparing legislation requiring financial disclosure for persons holding any of 500 key government positions. He said the EU and World Bank have both reviewed and approved the proposed legislation. (Comment: While such disclosure requirements seem a welcome step, Armenian law already prohibits public officials from owning businesses, a law that is routinely ignored or circumvented by placing assets in the name of family and friends. It is therefore difficult to determine what this new legislation, if enacted, would accomplish without serious enforcement mechanisms. End Comment).

18. (C) Kaidanow remarked that Armenia faces an interesting, but not unique, set of challenges. Many countries have dealt with similar challenges effectively, even in the former Soviet Union. Having worked in countries with similar legacies, she suggested that the GOAM must eliminate opportunities for corruption, and reform the tax system to bring in the grey economy. Reform of customs is both an economic and a security issue; the GOAM must be attentive to what enters and transits its territory, especially given the neighborhood in which it exists. The GOAM must also work to create a smaller space for corruption to flourish.

19. (C) Kaidanow indicated that with regard to technical

assistance, the USG will be helpful where it can, noting the EXBS program and USAID's tax reform program. Responding to Sargsian's reference to the bank supervision expert the USG had once provided to the Central Bank, Kaidanow indicated it might be possible to provide similar expertise to the tax service, but that the GOAM will need to show political will to undertake serious reform. Referring to comments made over the weekend by a visiting World Bank official that severely criticized corruption in Armenia, Kaidanow said such critical remarks have their benefits; only with international scrutiny of what the Armenian economy looks like is there likely to be impetus for change.

COMMENT

¶10. (C) We consider Sargsian a competent technocrat and believe he is serious about pursuing economic reform. We agree that without such reforms, Armenia has no future in a 21st century global economy. However, it remains unclear whether he has the political strength to battle the well-entrenched interests that have stymied previous attempts to bring reform to the notoriously corrupt and dysfunctional tax and customs services. Sargsian also has limited tools with which to address the current economic crisis, the causes of which are largely external. We hope that he will be able to use the crisis, however, to address the vulnerabilities it has exposed. End Comment.

¶11. (U) DAS Kaidanow has cleared on this cable.

YOVANOVITCH